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CPA Expert

AICPA Newsletter for Providers of Business Valuation, Forensic, & Litigation Services

Spring 2009

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2008 APEX® AWARDS FOR PUBLICATION EXCELLENCE

AICPA

CONTROLLING INTERESTS—DISCOUNT FOR LACK OF MARKETABILITY: PART 2

By Ronald D. DiMattia, CPA, ABV, CMA

My prior article (*CPA Expert*, Summer 2008) analyzed the concept of a discount for lack of marketability[1] for controlling ownership interests in privately held companies. The article analyzed the conceptual basis for such a discount and identified a possible source of empirical data, known as merger arbitrage transactions. As noted in the prior article, merger arbitrage transactions appear to have useful characteristics in assessing the discount for lack of marketability for controlling ownership interests.

In this article, I start with a brief overview of valuation theory as it relates to discounts for lack of marketability for controlling ownership interests. Then I analyze two key arguments against a discount for lack of marketability for controlling ownership interests: Control owners can (1)"put the stock in play" (begin the sale process) at their discretion and sell their ownership position and (2) can dictate the amount and timing of distributions to shareholders, and have the full benefit of cash flows until they sell their ownership position.[2] Analysis of both arguments finds them to be lacking in certain respects. As a result, it appears that a controlling ownership interest in a privately held company is most properly viewed as nonmarketable, and a discount for lack of marketability should be considered in valuing such an interest.

CONTROLLING OWNERSHIP INTERESTS AND VALUATION THEORY

As described in my prior article, some controversy surrounds the idea that a controlling ownership interest is most properly viewed as nonmarketable (or illiquid). The most authoritative argument against the view that controlling interests are nonmarketable is found in the following statements:

> *...The conceptual math for each enterprise level indicates that value is a function of expected cash flow, risk, and expected growth. If an appraiser adequately measures expected cash flow and the risks and growth of those cash flows, the result is an enterprise value.*
>
> *The argument against the existence of a marketability discount applicable to controlling interests is simple. If the enterprise value is determined based*

1 It is becoming more common for valuation analysts to distinguish between marketability and liquidity when analyzing the valuation result for a privately held company. This article, however, will continue with the more generalized use of the term *lack of marketability*, which would include the effect of illiquidity.

2 A third argument against a discount for lack of marketability for controlling interests could be the control owner's ability to cause the company to file for an initial public offering (IPO). Because an IPO is a remote possibility, at best, for most privately held companies, the argument is not analyzed in this article. For more information about the IPO argument, see "The Failed IPO Study: Insight Into the DLOM" by Gregg S. Gaffen, CFA, ASA, of Willamette Management Associates in the February/March 2005 issue of *Focus*, a newsletter of the AICPA Forensic & Valuation Services Section (Vol. 1, No. 2).

on expected cash flows, expected growth of those cash flows, and the riskiness of those cash flows, then what additional factors would support a discount from this value? The Integrated Theory suggests there are none.[3]

The stock market (in its collective wisdom) does the same thing in establishing prices for particular stocks. And for that moment when the stock price is evident, the risk/return characteristics of the stock are properly captured in its price (barring any unusual speculative influence). That is because valuation is a point estimate—an estimate at a given time. Additionally, valuation reflects *foreseeable* expectations of future events—both within and outside the subject company. Changes in price are inevitable over a period of time, because even foreseeable events do not occur exactly as expected.[4] As time goes on, the stock market continually re-evaluates the company, its expected cash flows, risk and expected growth of cash flows, and how these relate to the stock price. Minute-by-minute fluctuations in the stock market reflect these facts.

Therefore, any estimate of value on any given day is subject to risk because expectations of future events underlying the valuation estimate may not be realized. The difficulty arises when a price is accepted and then a lengthy period of time must elapse before that price can be realized in cash. When the time frame to actually realize the quoted value covers a lengthy period, it is reasonable to assume that the potential for significant fluctuations in stock price is meaningful.

The greater difficulty is that *unforeseen* events can occur which would cause the market to take a completely different view of the company, its expected cash flows, risk and expected growth of cash flows, and how these relate to the stock price. Lack of precision in interpreting foreseeable events combined with the potential for unforeseen events cause investors great concern because significant changes in a stock's valuation can result.

As a result, in order for a controlling ownership interest to be viewed as marketable, some important conditions must be met. First, there must be some certainty in actually receiving the quoted value in a timely fashion. Second, in an environment in which receipt of the quoted value is not timely and a stock price (or quoted value) has ample time and potential to vary widely, shareholder distributions must be sufficient to do three things prior to consummating the actual sale:

1. During the period prior to the sale being consummated, distributions must provide an implicit market-based return on the quoted value.
2. If the stock declines prior to the sale being consummated, distributions must provide an implicit market-based return on the quoted value long enough for the stock to rebound and then be liquidated at the quoted value.
3. If the stock does not rebound prior to the sale being consummated, distributions must compensate shareholders for the difference between the actual closing price and the quoted value.

These conditions relate to the two key arguments cited earlier that are often advanced to support the position that controlling ownership interests are marketable. The arguments are analyzed in the following paragraphs.

SALE OF STOCK

It is widely assumed that a controlling owner can put the stock in play, presumably at their discretion, and liquidate their ownership position. But the ability to put a stock in play does not immediately result in cash and is not always successful.

3 Z. Christopher Mercer and Travis W. Harms, *Business Valuation: An Integrated Theory*, Second Edition (New Jersey: John Wiley and Sons), pp. 94-95.

4 A common element in the Statement of Assumptions and Limiting Conditions in many valuation reports is the following: "We do not provide assurance on the achievability of the results forecasted by [ABC Company] because events and circumstances frequently do not occur as expected; differences between actual and expected results may be material; and achievement of the forecasted results is dependent on actions, plans, and assumptions of management." Statement on Standards for Valuation Services No. 1, issued by the AICPA Consulting Services Executive Committee, June 2007, page 37, number 4.

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As demonstrated in my prior article, the time to complete a transaction can be lengthy and the risk of failure is meaningful even for the most marketable entities in America—publicly traded companies.[5]

Empirical data show that from the announcement of a transaction to acquire a publicly traded company until its closing, the time period averages three months or more.[6] Anecdotal evidence indicates that the sale of a privately held company requires 9 to12 months.[7] These periods of time are not inconsequential because during the period any number of events could occur; one being the failure of the transaction.

Empirical data also show that the failure rate of announced acquisitions of publicly traded companies is roughly 20%, and anecdotal evidence indicates that the failure rate is as high as 80% in the sale of privately held companies.[8] In times of economic upheaval (as we find ourselves in currently), a lengthy period between announcement and closing of a transaction heightens the potential for deal failures. For example, several high-profile transactions ended in litigation because the buyer could not justify a price, which subsequent events demonstrated was too high.[9]

Even a cursory review of stock charts shows that any given stock's price can vary widely over a very short time period—even over just a few days' time. As the length of time grows, the opportunity for variation becomes greater. Certainly, stocks can and do go up in price and investors reap the benefit. But because investors are risk averse, they are principally concerned with the risk that the stock price (or quoted value) will decline. Unfortunately, the current market environment amply demonstrates that stocks can experience severe declines. Many publicly traded companies have experienced share price declines of 50% or more during a two to three month period.

So even though a control owner can begin a sale process, it is not likely that they will receive the proceeds in a timely fashion. Furthermore, it is not a certainty that they will realize the quoted value of the stock—the price could be lower, or the deal could fail outright. As a result, an owner's ability to begin a sale process is not sufficient alone to characterize a controlling ownership interest as marketable.

SHAREHOLDER DISTRIBUTIONS

A controlling owner's ability to dictate distributions is the cornerstone of the argument that controlling ownership interests should be considered marketable. But events of the last 18 months clearly indicate that the ability to control distributions is not free from risk. Although extreme, these events are instructive of the types of concerns investors have. A number of large and well-known companies stopped paying dividends, or reduced them dramatically.[10] As recent events have shown, even if a controlling owner desired to make distributions he or she could be precluded from the decision for a variety of reasons including the following:

- Financial markets could shift, causing the firm to retain substantially all of its free cash flow to correct its financial position (as happened recently in the banking sector).
  - It is important to note that the idea of a "credit crunch" is not unique. The U.S economy went through a milder credit crunch in the early 1990s.
- Unexpected operational issues could develop, requiring the company to conserve cash for an extended period (such as a labor strike, several of which occurred in 2006/2007).

It is not a certainty that a controlling owner will always have a certain amount of cash to distribute. Often there are periods when the need to maintain operations will take precedence over the controlling owner's desire to distribute cash. These periods can be quite long. Smaller privately held companies seem to be much more susceptible to variations in distributable cash flow because of inferior access to capital markets and less diverse operations. From a valuation perspective this is critical, because without the certainty of receiving cash on a regular basis investors are subjected to additional risk from which they seek protection.

The close link between value and cash flow is also problematic for supporting the idea that controlling ownership interests are marketable. When a company's stock price falls from the quoted value prior to being sold, the reason is often that expectations of future cash flows have been compromised in some respect. Certainly macroeconomic or deal-specific issues could have an effect, but even these would often have some impact on expectations of the company's future cash flows. In an environment of a lower share price and potentially compromised cash flows, is it reasonable to assume

5 Ronald D. DiMattia, "Controlling Interests — Discount for Lack of Marketability: The Empirical Evidence," *CPA Expert*, Summer 2008, pp. 1-6.
6 DiMattia, p. 4.
7 DiMattia, p. 3.
8 DiMattia, pp. 3-5.
9 Examples include the Dow Chemical/Rohm & Haas transaction (which litigation settled as this article was being written) and the Huntsman/Hexion transaction.
10 Examples include Alcoa, Capital One, CBS Corp., Cedar Fair, Wells Fargo, US Bancorp, PNC, J.P. Morgan Chase and General Electric, among others.

that the control owner can create a market-based return on the quoted value until the stock rebounds? Is it reasonable to assume that the control owner could distribute enough cash to make up for the difference in valuation if the stock does not rebound? Perhaps, on both counts, but it would depend on how far the stock has fallen, how deeply the cash flows have been compromised, how likely the price is to rebound, and the time frame of the hoped-for rebound. Given a large enough correction in the stock price or distributable cash flows, one is hard pressed to imagine a scenario that could work.

Practical concerns also present problems for the argument that a control owner can dictate the amount and timing of distributions prior to a sale being consummated. Generally, controlling ownership interests are sold pursuant to the terms of a letter of intent; the terms are formalized and finalized in a purchase agreement. Most terms of a letter of intent are nonbinding, but the letter does set forth each party's expectations about basic elements of the final purchase agreement, the conduct of the parties prior to closing, and the ability of either party to terminate negotiations. Many of these agreements set forth an expectation that the owner will not distribute cash outside the normal course of business prior to the transaction closing. Additionally, purchase agreements often contain a formal representation that the seller has not made any distributions outside the normal course of business in the period prior to the transaction closing.

Interim cash flows that a control owner can direct to shareholders would certainly be a risk or contingency that a valuation analyst must consider in assessing a discount for lack of marketability. But the opportunity for it is not so complete and determinative as to negate the consideration of a discount for lack of marketability. Practical matters, risks and contingencies associated with future cash flows as a support for marketability are too great to ignore.

CONCLUSION

This article demonstrates that, from both a theoretical and practical standpoint, controlling ownership interests in privately held companies are most properly viewed as nonmarketable. Given that selling a controlling ownership interest is not an immediate event, risk in actually realizing the quoted valuation is substantial. Investors are not capable of perfect foresight, and as time progresses one would expect investors to re-evaluate the basis of their valuation. More troubling is the emergence of unforeseen events, which can have a significant impact on an investors' valuation. Therefore, the argument that controlling interests are marketable relies on the owner's ability to 1) put the stock in play and 2) direct distributions to shareholders.

However, an owner's ability to put the stock in play is not sufficient to characterize a controlling ownership interest as marketable. Empirical evidence indicates that the time to realize the quoted value in cash is lengthy and the risk of deal failure is meaningful. Stock market data also indicate that the potential for a significant fall-off in valuation during the period prior to a transaction being consummated is meaningful.

Similarly, an owners' ability to direct distributions to shareholders is not sufficient to characterize a controlling ownership interest as marketable. It is not a certainty that a controlling owner will have sufficient cash available to make distributions to shareholders. Additionally, from a practical perspective a control owner's ability to make distributions often is severely restricted during the period prior to a transaction being consummated.

Because investors are risk averse, they are concerned with the potential for a price decline from the point of the quoted value to the point it is realized as cash. Our attempt, then, is to measure how much protection an investor will require to accept a point estimate of value, knowing that it will not be realized until a meaningful period of time has elapsed. Offsetting this risk would be the interim cash flows that can be distributed. Even so, meaningful risks exist for the controlling owner, and it is logical to expect that a rational investor would seek protection from such risks. The expected form of such protection would be a discount to reflect the relative lack of marketability.

To be sure, marketability is a concept that is heavily influenced by the valuation analyst's judgment. A guidepost, then, would be useful to help form the analyst's judgment. The previous article in *CPA Expert,* Summer 2008, indicated that studies of merger arbitrage could be a good indicator of the lack of marketability of a controlling ownership interest. The spread in these transactions reflects arbitrageurs' estimates of the risk that expectations of future events will not occur as planned in the period prior to closing. Although more research is needed, it would appear that studies of merger arbitrage could be a useful guidepost.

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Expert OPINION

IN RE MARRIAGE OF THORNHILL: EMERGING ISSUES IN STANDARD OF VALUE DETERMINATIONS FOR FAMILY LAW MATTERS

By Brenda M. Clarke, CPA/ABV/CFF, CVA, and Ronald L. Seigneur, MBA, CPA/ABV/CFF, CVA

Many business analysts focus a substantial portion of their practice on family law matters, including the valuation of ownership interests in closely held businesses and professional practices. As in most valuation engagements, the initial threshold questions to be resolved before proceeding to develop a work plan, inclusive of a request for the required information, include the determination of the appropriate standard of value, the premise of value, and the date of value to use for the underlying analysis and opinion.

Most analysts are accustomed to having their client or client's legal counsel provide these three fundamental elements. As we know, without employing the proper standard of value, one cannot expect to get the right answer to the valuation conclusion being sought. To complicate this matter, the proper standard of value for family law matters varies in different jurisdictions. Some states define the proper standard of value by statute, such as Arkansas[1] and Louisiana,[2] whereas other states rely on prior litigated precedents, such as New Jersey[3] and California.[4]

Recently, a family law valuation matter in Colorado received significant attention because of its relationship to the standard of value question. In the case *In re Marriage of [Chuck and Antoinette] Thornhill*,[5] the trial court allowed for a 33% discount for lack of marketability, using a Fair Market Value standard, on a 70.5% controlling interest in an oil and gas business located on the western slope of Colorado. The application of a Fair Market Value (FMV) standard was appealed to the Colorado Court of Appeals, which ruled that the trial court did not abuse its discretion in rendering its decision. The appellate decision has recently been granted a Writ of Certiorari before the Colorado Supreme Court (the Court) on two distinct and separate issues.

The first issue to be considered by the Court relates to the basis of the trial court's award of a temporary maintenance award and is beyond the scope of this article. The second issue is whether the trial court erred in not considering the findings in *Pueblo Bancorporation v. Lindoe, Inc.*[6] (Pueblo/Lindoe),[7] which effectively established the guidelines for application of the Fair Value standard in Colorado cases involving dissenting and oppressed shareholders. The Court ruled in the Pueblo/Lindoe matter that Fair Value in Colorado is equivalent to Fair Market Value without the application of a discount for lack of marketability. It is widely accepted in Colorado that this is now the appropriate standard for these types of litigated proceedings, but, heretofore, there has not been any consensus about whether the Fair Value standard, as defined in Pueblo/Lindoe, is appropriate in the determinations of value for equitable distribution in family law matters.

In its ruling, the appellate court stated the following:

> We conclude the considerations that underlie the *Pueblo Bancorporation* decision are inapplicable in a dissolution proceeding for several reasons. The dissolution statutes do not contain the 'fair value' language of section 7-113-101(4) that was critical to the court's analysis. Its comprehensive review of similar statutes in other jurisdictions led to its conclusion that 'fair value' does not mean 'fair market value,' and, as a result, the common practice of including a marketability discount in calculating fair market value is not permitted in dissenting shareholder valuations.

The court went on to say the following:

> We are instead persuaded by the decisions of numerous other jurisdictions that have concluded

1 Arkansas Code §9-12-315.(4).
2 Louisiana Code §9-2801-(1)(a); 9:2801.2.
3 *Brown v. Brown* 348 N.J. Superior Ct. 466; 792 A.2d 463.
4 *Golden v. Golden*, 270 Cal. App. 2d 401, 75 Cal. Rptr. 735 Cal.App.Dist.2; March 5, 1969.
5 *In re Marriage of Thornhill*, 2008 WL 3877223 (Colo. App.) (Aug. 21, 2008).
6 Ibid.
7 *Pueblo Bancorporation v. Lindoe, Inc.*, P.3d 353 (Colo. 2003).

marketability discounts may be applied in valuing shares in closely held corporations in dissolution proceedings. Such a discount would be applied to reflect the fact that shares of stock in such corporations are less marketable than publicly traded stock, a factor that an ordinary buyer would take into consideration in deciding what to pay for the shares.

The cross petition for Writ of Certiorari was granted in mid-February 2009 to hear the issue of whether the appellate court erred by refusing to extend the holding of Pueblo/Lindoe to divorce proceedings, thereby allowing the application of a marketability discount in valuing a closely held corporation operated as a going concern at the time of the parties' dissolution of marriage proceeding.

The trial court relied on testimony submitted by separate experts retained by both the petitioner and respondent. Apparently the court found more compelling the evidence and testimony of the petitioner's expert, who had utilized a Fair Market Value standard and applied the 33% lack of marketability discount to Mr. Thornhill's 70.5% ownership interest in his oil and gas business.[8] A couple of factors identified by the appellate court are also worth noting. The wife was not represented by legal counsel when the parties entered into a separation agreement providing for maintenance and dividing the marital estate. At the time of the scheduled trial court hearing to enter into a final decree, the wife realized that she did not have a good understanding of the value of the marital assets and, therefore, disavowed the original separation agreement as being unfair to her. It is interesting to note that she was assisted in negotiating the separation agreement by her father, who happened to be the CFO of the husband's business at the time. The appellate court noted that purely by virtue of his role as CFO of the husband's business, the father was required to attempt the preservation of the business assets, which resulted in dual loyalties.

The appellate court concluded that the considerations that underlie the Pueblo/Lindoe decision are not applicable in a dissolution proceeding for "several reasons," including that the state statutes do not contain the "fair value" language that was critical in the Pueblo/Lindoe decision. The same court also declined to adopt the holding of the New Jersey landmark case *Brown v. Brown*[9] in which the New Jersey appellate court extended the reasoning of cases under New Jersey dissenting shareholder statutes to hold that marketability discounts are not appropriate in dissolution proceedings. Instead, the appellate court stated that trial courts in dissolution cases act as courts of equity and should have discretion whether to apply marketability discounts in valuing closely held corporations in dissolution proceedings, while stating that the court expressed no opinion about the amount or percentage of the discount that may be applied. It continued by stating that trial courts should make a clear record about the reason for applying a given discount rate to facilitate review on appeal.

The finding and application of valuation theory and concepts in this matter raises the following key issues that are worthy of note by valuation analysts:

1. What is the proper standard of value in family law matters in Colorado?
2. How is a 33% lack of marketability discount justified on what appears to be a 70.5% controlling interest?
3. When the facts indicate that there is an identified "buyer" in the instance of family law matters, based on prior appellate precedents in the subject jurisdiction, can the Fair Market Value or Fair Value standards be used, given the commonly accepted definitions of each of these standards?
4. If the subject ownership interest was not controlling, would the trial court have allowed a discount for lack of control or minority interest?

Many states, such as Arizona,[10] California[11] and Kentucky[12], have recognized precedents that reflect the concept commonly referred to as *value to the holder* under an investment value premise, which is sometimes referred to as the value the propertied spouse would be willing to pay into the marital estate to retain the benefits of their ownership interest in a business or professional practice. This concept relies on the notion of an identified seller (the propertied spouse) and, therefore, runs contrary to the requirement for a hypothetical willing buyer under Fair Market Value.[13]

In other words, the assumed seller used in the Value to the Holder premise is the owner of the interest, and this moves the focus to Investment Value in terms of what this specific buyer is willing to pay into the marital estate to retain the rights and benefits of the interest. With this in mind, we can envision a spectrum of

8 It is important to note that all family law cases are sealed at the Colorado Court of Appeals and therefore it is not possible to review any of the pleadings or findings.

9 792 A.2d 463 (N.J. SupCT. App. Div. 2002).

10 *Mitchell v. Mitchell* 152 Ariz. 317 732 P. 2d 208 (1987).

11 See footnote no. 4.

12 *Clark v. Clark,* 782 S.W. 2d 56 1990 Ky. App. Lexis 3 (Ky. CT. App. 1990).

13 Defined in the current edition of the *International Glossary of Business Valuation Terms as* "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

the premise of value ranging from what the Fair Market Value would be between a willing buyer and willing seller in an assumed exchange to what the Investment Value would be to the specific holder of the interest. In most appraisal settings, discounts for lack of marketability and lack of control are explicitly relevant in an assumed exchange transaction, whereas similar discounts would not necessarily be relevant or appropriate for the value proposition to a specific identified holder of the ownership interest when an imminent sale or an assumed exchange between a buyer and seller is not expected to occur.

Consistent with this range of value premise, we believe Colorado has followed an Investment Value and Value to the Holder approach, based on the findings in *In re Marriage of Graff,*[14] *In re Marriage of Martin*[15] and *In re the Marriage of Huff.*[16] In all of these decisions, the court makes specific reference to the value being what the propertied spouse would pay for the ownership interest in question, as opposed to what a hypothetical buyer would be willing to pay. The propertied spouse obviously brings an entirely different orientation to the table because he or she would typically have motivations and reasons why he or she would pay a higher value into the marital estate to retain the rights and entitlements of the ownership interest in question. In an Investment Value and Value to the Holder premise, there is typically little rationale for a discount for lack of marketability of any magnitude.

For example, in the Huff case, the appellate court noted that the valuation method used was appropriate because it provided the best indication of the value of the husband's interest in his law practice partnership to himself, as opposed to another willing buyer or seller. The appellate decision also noted that an individual practitioner's inability to sell his or her interest in the practice does not eliminate the existence of goodwill and its value as an asset to be considered in equitable distribution, and such equitable distribution does not require conveyance or transfer of any particular asset. Similarly, in the Martin case, the appellate court noted that the value of goodwill is not necessarily dependent upon what a willing buyer would pay for such goodwill, stating that the important consideration is whether the business interest has value to the propertied spouse above and beyond the tangible assets. In the Graff case, the appellate court noted the value of the subject's State Farm insurance agency ownership interest should be based on what the agency was worth to the owner, notwithstanding specific restrictions on the transfer of the insurance agency by State Farm. The Graff decision also specifically noted that the value of goodwill is not necessarily dependent upon what a willing buyer would pay for such goodwill; rather, the important consideration is whether the business has value to the spouse over and above the tangible assets.

Notwithstanding significant Colorado family law precedent that primarily supports an Investment Value and Value to the Holder premise, it is clear so far that if the trial court wants to apply an alternate Fair Market Value standard, such as that adopted in *Thornhill*, then a discount for lack of marketability may well apply. The key point here is that it is routinely more of an issue with noncontrolling interests under FMV, versus the 70.5% ownership Mr. Thornhill controlled in the subject business, in which it is considered unreasonable to take such a large discount. Most often, controlling interests in closely held businesses are not discounted at all for lack of marketability under even a Fair Market Value standard. This is due to the fundamental fact that the controlling owner can indeed decide to sell at any time, and often quite efficiently, notwithstanding the absence of a public market. Unfortunately, the magnitude of the discount allowed in this case for a controlling interest is not an issue that will be heard by the Court.

If the Thornhill interest at issue had been a 20% share of the enterprise, many valuation analysts would begin to be much more comfortable with lack of marketability discounts approaching a 25% to 35% range, similar to what was utilized in *Thornhill.* This smaller minority interest might also require consideration of a discount for lack of control or minority interest, often of a like amount under a Fair Market Value standard. Both discounts are very fact-specific and draw upon numerous sources to help support the proper levels.

Valuation analysts typically are provided with the proper standard of value to use in their appraisal assignment, along with the proper premise of value (for example, going concern versus liquidation) and date of value, at the onset of their engagement. When the trier of fact in equitable distribution cases can determine the proper standard of value based on the facts and circumstances of each case, we can expect to see wide variations in the ultimate finding of value for the subject closely held ownership interest in businesses and professional practices. This is because of the magnitude of the impact (for example, up to 50% or 60%) on whether the aforementioned discounts are deemed appropriate. In some instances, the analyst will

14 *In re Marriage of Graff,* 902 P. 2d 402 (Colo. Ct. App. 1994).
15 *In re Marriage of Martin,* 707 P. 2d 1035 (Colo. Ct. App. 1985).
16 *In re the Marriage of Huff,* 834 P. 2d. 244.

need to provide conclusions under more than one standard of value to allow the trier of fact to evaluate what value is ultimately deemed appropriate in any specific case in which the proper standard of value remains undefined, as is the case presently in Colorado.

An important point of comparison with all of this is to evaluate how the premise and standard of value choices are used in other appraisal disciplines, such as real estate, which if done right, uses a similarly defined fair market value standard[17] and draws much of its work from use of market comparables. Embedded within the use of the market method in real estate appraisals is an inherent discount for the marketability or lack thereof of the subject property. This often creates baseline confusion in comparison to business appraisal indications under a Value to the Holder premise in which marketability discounts are not applied. For a trier of fact, this creates an environment in which some assets (for example, closely held businesses) are not subject to reductions in value for discounts for lack of a ready market, while other marital assets (for example, the marital home and owned autos) are effectively discounted.

One thing is certain in the final analysis here. It is very clear that there are great distinctions in what standard of value is appropriate between jurisdictions and that states with the standard of value for dissolution of marriage proceedings based on court case precedent can be expected to have an ever-evolving landscape, such as is the case currently in Colorado.

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17 It should be noted that fair market value in real estate valuation has slightly different distinctions, such as time allotted for exposure to the marketplace.

INTERVIEW SAFETY AWARENESS

By Randal A. Wolverton, CPA/CFF, CFE

Forensic accountants and other accounting professionals have more interview training opportunities than ever before; however, interview safety is often neglected. Are CPAs exposed to violent encounters in their everyday practice? Probably not. Such violence may be so rare that statistics on such situations may not even exist. However, the truth is that the potential is real, and the consequences may be dire. With a little knowledge and planning, interviewers can avoid exposure to potential violence.

As more fraud schemes are being uncovered in a declining economy, professional accountants, by virtue of their knowledge of the books and records as well as the operations of an organization, understandably are relied upon to assist with fraud investigations. Fraud-related engagements make the chances of encountering a fraud suspect or suspects more likely, but many engagements may not start with the expectation of discovering fraud. The fact-finding process can quickly turn into a fraud matter, thereby changing the dynamics of contacts and interviews.

As always, advice of counsel should be sought if allegations of fraud are discovered during an engagement, especially if the accountant has little or no experience in conducting a fraud investigation.

Although violence against accountants may not occur often, it has happened on occasion. The rising frequency and severity of such workplace violence not only is disturbing but also is getting increased media attention and is becoming the subject of more formal studies. It also is not surprising that workplace violence has resulted in a number of injuries and fatalities across the United States. Statistics confirm that, on many occasions, the perpetrator directs the violence at whomever he or she feels is responsible for taunting, disciplining or dismissal. It is worth noting that many perpetrators resort to extreme violence when finally overwhelmed by circumstances, but the events leading to their angst have occurred over time. How do we know when some people reach the breaking point? The answer is that we don't, but we can recognize signs of discord that should raise our concern in certain interview situations.

Trained law enforcement officers know that, although violence is less frequent in financial crime investigations than other types of investigations, such encounters can occur. Knowing that violence is less frequent may make it very easy to be lulled into complacency when dealing with white-collar crime witnesses and suspects. Just as there is no "routine" car stop, there also should never be a "routine" interview when dealing with potential fraud. Consider that persons committing fraud will know whether the interviewer asking the questions is a law enforcement officer armed with weapons, handcuffs and arrest powers. The same suspects also will know that an accountant is not. Therefore, recognition and reduction of risks become more important.

PREPARING FOR THE INTERVIEW

Much can be done prior to an interview to identify and reduce potential risks. Professional accountants are typically skilled in documentation, accuracy and preparation, and they can use the same skills to reduce risks in the interview process. Consider the following recommendations:

1. *Employee and engagement data.* If traveling outside the office, inform someone at the home office of the date, time and location of the interview, the participants, and the expected time of return. Also leave at the office descriptions and license numbers of vehicles being driven to the engagement.
2. *Telephone contact checks.* Leave with someone at the home office a contact telephone number at the destination and a personal cell phone number. Before leaving the office, make a quick check to determine if your cell phone is operational and charged. If possible, you should know whether your cell phone has coverage at your destination. In the event of an emergency, a 911 operator will want to know immediately the full names of the persons involved; their approximate ages, physical descriptions, clothing descriptions, cell phone numbers and vehicles and license numbers; the full addresses of locations involved and other pertinent data.
3. *Partner interviews.* Avoid situations in which you are asked to meet a person alone, particularly if the person is not well known to you. Having a second person as a witness during an interview is recommended for practical as well as safety reasons. A coworker as a witness also may reduce the chances of false accusations of misconduct.
4. *Locations.* If possible, conduct interviews in business locations during normal business hours when other persons are on the premises. Interviews in hotel lobbies may be appropriate but interviews in hotel rooms are probably not. Avoid interviews in bars, parking lots and private vehicles. Discourage the use of alcohol during professional engagements. Although interviews in private homes can be appropriate if the interviewee is known and trusted, view the situation with caution. Interviews in government buildings will offer screening devices that provide assurance that firearms and other weapons are removed. Also, consider conducting interviews in your home office in a room with furniture arranged to enhance safety as well as effective communications.
5. *Identity of persons contacted.* If you are unfamiliar with the person being interviewed, ask for a business card. View the business card carefully and retain it for your records. Always ask for full names, addresses, contact numbers and job descriptions. Try to gather this information in advance when arranging a date and time for a meeting.
6. *Dress and demeanor.* An interviewer and partner should always be appropriately dressed and conduct themselves in a courteous and professional manner. Avoid disclosing personal information about yourselves during the interview.
7. *Trust your instincts.* Although you cannot conduct a thorough background check on the person being interviewed, you can change the date and location of an interview if you believe that something is amiss. If you're uneasy, take control of the circumstances until you reach your desired comfort level. It is easy to explain changes by saying that company policy dictates the circumstances of interviews.

DURING THE INTERVIEW

Once at the interview location, interviewers need to maintain their guard. The following recommendations will help interviewers to recognize and deal with threatening situations:

1. *Awareness.* The vast majority of contacts by professional accountants will proceed without safety problems; however, our awareness and skepticism should continuously increase as we move closer to the subject of fraud. Remember, many fraudsters have been concealing a scheme for long periods of time, so you may be viewed as an immediate threat to their plans.
2. *Interview location.* When you first enter the room to be used for an interview, take a mental note of the layout. In the event of a problem, do you and your partner have an escape route? Try to avoid a situation in which an angry person or other physical obstacles can block your exit. Also, if an interviewee becomes angry, does he or she have an escape route that does not involve going through you? You should consider having a table or other piece of furniture between you and the person being interviewed. Take a mental note of objects in the room that could be used as weapons against you or that you might use to protect yourself, such as telephones, objects on desks and tables, lamps, small chairs and so on.
3. *Physical red flags.* During an interview, be aware of behavioral reactions that may indicate stress, uneasiness, or even anger. Increased perspiration, dryness of the mouth or a cracking voice can be an indication of internal turmoil.
4. *Oral red flags.* If you listen carefully, a person under stress may provide clues to potential outbursts. Our concern and skepticism should intensify if the person being interviewed makes comments about violence, excessive alcohol or drug use, depression, abusive relationships, anger, resentment, financial problems or threats.
5. *Admissions and confessions.* A person confessing to misconduct may be

viewing his or her world as falling apart and see the persons in the room as bearing some blame for the situation. Depression and anger are common in these circumstances and may influence the thinking of the person confessing to improper conduct. Many people have expressed relief while calmly confessing to serious misconduct, but do not be fooled into complacency. As an example, a person being treated for depression may have the benefit of powerful drugs to control mood swings. What if he or she did not take the medication that day? Also, consider that if you arranged the interview in advance, the person may believe that he or she will be confronted with incriminating information, thereby raising his or her anxiety level. As the interviewer, you will most likely not know this prior to your arrival.

6. *Worst-case scenario.* Preparing in advance for potential dangers may be the difference between a positive resolution of a bad situation or something much worse. In an emergency, can you protect yourself? If necessary, can you escape an enclosed location, put distance between you and danger and relay accurate information to authorities?

Many of the preceding recommendations may seem obvious and intuitive; however, an emergency situation is not the time to be planning your actions.

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MADOFF "GAMED" THE SYSTEM

Annette M. Stalker, CPA/CFF, CFE, and Michael G. Ueltzen, CPA/CFF, CFE

Through a combination of leadership in regulatory organizations, the opaque nature of his operations and his seemingly philanthropic endeavors, Bernard Madoff was uniquely positioned to exploit regulatory gaps for personal gain.

For more than 30 years, the unparalleled Ponzi scheme Madoff conducted escaped detection. Many wonder "How could this happen?" and "Where were the regulators?" Yes, Madoff operated in a highly regulated environment, but there is a fine line between reasonable, effective regulation and burdensome rules that eliminate the small broker-dealers and investment advisers, as well as professionals providing services to them.

Early in his career, Madoff became involved with the launch of the National Association of Securities Dealers (NASD), a self-regulatory agency for broker-dealer firms. The NASD later created the NASDAQ stock exchange on which Madoff served as chairman of the board from 1990 to 1993. In effect, Madoff helped shape the rules for private broker-dealers, which were enforced by the NASD[1] and the Securities and Exchange Commission (SEC). Many of Madoff's close relatives held positions in several financial sector agencies, including the Financial Industry Regulatory Authority's (FINRA's) compliance board, the NASD, the National Adjudicatory Council (mutual fund task force) and the Securities Industry and Financial Markets Association (securities firm trade association). Many financial services regulators and leaders looked to Madoff for input and guidance on the rules.

On a personal level, Madoff appeared to be a generous benefactor of the Jewish community. He gained their instant trust, based on his apparent contributions, upstanding character and financial acumen. In the world of Ponzi schemes, a fraudster can gain access to later victims through this type of "affinity group."

In this case, it is particularly troubling that Madoff preyed on many charitable foundations and pensioners. These organizations and individuals depended completely on the promises of a fraudster who lied, cheated and stole for decades.

Even with such a cunning and convincing fraudster, many wonder "Shouldn't there have been checks and balances in place to ensure one person could not wreak so much damage?"

WHAT WAS THE REGULATORY ENVIRONMENT?

Broker-Dealer Oversight

The SEC regulates the activities of securities broker-dealers under the Securities Exchange Act of 1934 (Exchange Act). FINRA, a self-regulatory organization funded through broker-dealer participant fees, was formed in 2007 by combining the NASD with the New York Stock Exchange's member regulation, enforcement and arbitration functions. FINRA provides education, conducts examinations and writes and enforces rules for registered broker-dealers but not for investment advisers. Madoff was instrumental in developing the governing rules through his role on the boards of the NASD, the NASDAQ and other agencies.

1 In 2007, the National Association of Securities Dealers and the New York Stock Exchange's member regulation, enforcement and arbitration division merged and became the Financial Industry Regulatory Authority (FINRA).

Investment Advisory Oversight

The activities of investment advisers are governed by the Investment Advisers Act of 1940 (Advisers Act), and the activities of investment companies are governed by the Investment Company Act of 1940. The SEC, not FINRA, is the sole agency authorized to enforce the Advisers Act.

Bernard L. Madoff Investment Securities LLC (BLMIS) was unique in that Madoff was both a registered investment adviser and a broker-dealer. The full extent of assets under management was never visible to any one regulatory body because of his extensive use of "funds of funds." Also, because he did not charge fees for asset management but only for trade execution, no revenue would have been reported as asset management fees. Madoff avoided registering with the SEC as an investment adviser until 2006, following an SEC investigation related to his investment advisory business.[2]

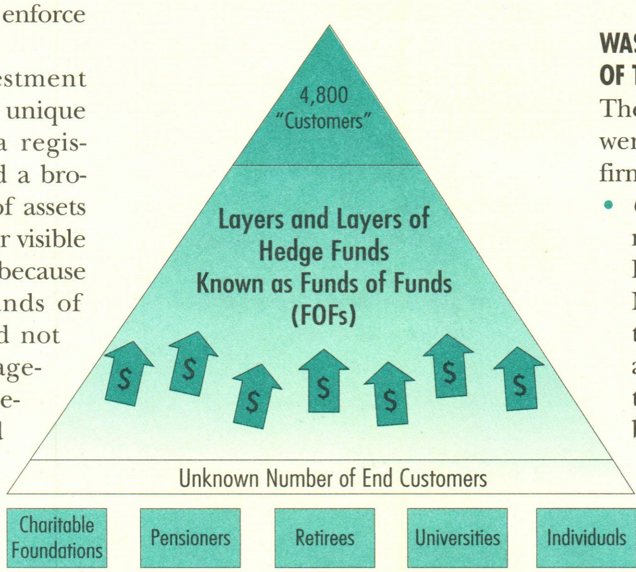
Madoff was able to deflect SEC and FINRA regulatory oversight because of his knowledge of the overlapping duties and responsibilities of the two organizations. Madoff gamed the system.

Many of the various funds (both direct and indirect investors to Madoff) that were invested wholly or partially in Madoff had an investment adviser. They were typically responsible for determining and placing the funds' monies into investment vehicles and ensuring that the nature of investments were in line with the fund agreement and placement memorandum criteria. These advisers were registered with the SEC.

Madoff deflected SEC oversight by using other organizations that were required to be registered with the SEC as investment advisers to serve as the intermediary for investments in the Madoff funds. Madoff gamed the system.

Madoff Pyramid

Madoff, "shadow" Investment Adviser



Independent Accountant Oversight

The Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board (PCAOB), which was designed to oversee the auditors of public companies. An accounting firm registered with the PCAOB is subject to the standards set by the PCAOB, as well as oversight and enforcement.

Audits of entities that are required to file financial statements under Section 17(e) of the Exchange Act must be performed by independent accounting firms registered with the PCAOB. Beginning in August 2003, the SEC issued a series of orders granting nonpublic broker-dealers temporary exemptions from the obligation of filing financial statements audited by registered public accounting firms. Madoff filed an Annual Form X-17A-5. The face sheet of the form indicates several financial statements and reports are included; however, only the statement of financial condition is publicly available.

Madoff was careful to select a CPA firm not registered with the PCAOB and not subject to professional peer review. Madoff gamed the system.

WAS MADOFF ABLE TO TAKE ADVANTAGE OF THE REGULATORY EXCEPTIONS?

The following regulatory exceptions were in place for private securities firms, such as BLMIS:

- *Custody rule exception.* An amendment to the Advisers Act through Rule 206(4)-2 became effective November 5, 2003, and provided that certain registered investment advisers who use a qualified custodian (for example, a registered broker-dealer) to maintain client assets were no longer required to submit to annual surprise audits by an independent public accountant as long as the custodian sends periodic account statements to the adviser's clients at least quarterly. BLMIS was both an investment adviser and qualified custodian via the registered broker-dealer status pursuant to Section 15(b)(1) of the Exchange Act. Despite the exception to the custody rules for investment advisers, the SEC complaint against David Friehling of the Friehling and Horowitz CPA firm indicates that internal control reports for BLMIS were filed annually. Based on other media reports, it appears that Frank DiPascali, referred to as a key lieutenant of the Madoff firm, may have sent audit reports and internal control reports prepared by Friehling and Horowitz and other account statements to clients, other independent accountants or both.
- *Accountant registration exception.* Section 17 (a) of the Exchange

2 To put the magnitude of oversight into perspective, the Securities and Exchange Commission (SEC) currently has oversight of more than 5,000 reporting companies; 5,500 broker-dealers; 11,000 investment advisers and, in conjunction with FINRA, in excess of 600,000 registered representatives. In the most recent year, the SEC conducted examinations of 1,500 investment advisers and, in conjunction with FINRA, in excess of 55% of the registered broker-dealers.

Act requires registered broker-dealers to provide certain “certified financial information“ to the SEC and customers; Section 17(e) was amended in 2002 by the Sarbanes Oxley Act to require that the financial information of the issuer be certified by a “registered public accounting firm” of the PCAOB. This requirement had been continually deferred by the SEC through a series of releases through fiscal years ending before January 1, 2009.

Selecting the Friehling and Horowitz CPA firm was a deliberate act to avoid PCAOB and professional peer review oversight. Madoff gamed the system.

WERE MADOFF’S HEDGE FUND CLIENTS SUBJECT TO REGULATION?

Private hedge funds are not currently required to be registered with the SEC; however, approximately 20% of all fund firms have registered with the agency since 2006. Madoff’s use of the “split strike conversion” [3] hedge provided him the cover of a seemingly plausible investment strategy.

Because registration is not required, the SEC does not have purview over the magnitude of funds involved and, therefore, at risk.

Once again, Madoff carefully selected investment vehicles that were not subject to extensive oversight by the SEC or others. Madoff gamed the system.

In addition to engaging an accounting firm not registered with the PCAOB and dealing with hedge funds, Madoff avoided in-depth oversight by the SEC and FINRA because of the lack of a coordinated oversight program of broker-dealers and investment advisers. Evidence also exists that Madoff lied to the regulators and apparently contacted some of his investors in advance of SEC investigations.

Madoff gamed the system to the great detriment of thousands.

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3 Madoff’s purported split strike conversion strategy involved the purchase of indexed stocks and the use of put and call options at predefined prices to establish a ceiling and floor. Madoff would sell “out of the money” and into government-backed securities according to proprietary market indicators.

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